

rather than an employer-wide basis to all of the plans or portions of plans taken into account in determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement, regardless of whether one or more of those plans or portions of plans is tested under the special rule § 1.414(r)-1(c)(2)(ii). This requirement applies solely for purposes of determining whether the cash or deferred arrangement is a qualified cash or deferred arrangement under section 401(k) and this section. The rules of this paragraph are illustrated by the following example.

*Example.* (i) Employer A maintains a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with § 1.414(r)-1(b) for purposes of applying section 410(b). However, Employer A applies the special rule for employer-wide plans in § 1.414(r)-1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans). Employer A makes qualified nonelective contributions to the profit-sharing plan for the 1995 plan year, and the profit-sharing plan provides that these qualified nonelective contributions may be used to satisfy the actual deferral percentage test.

(ii) Under these facts, the requirements of sections 401(a)(4) and 410(b) must be applied on an employer-wide rather than a qualified-separate-line-of-business basis in determining whether the qualified nonelective contributions made to the profit-sharing plan satisfy the requirements of § 1.401(k)-1(b)(5), and thus whether they may be taken into account under the actual deferral percentage test. Therefore, in order for the nonelective contributions to be used to satisfy the actual deferral percentage test, both (1) the total amount of nonelective contributions under the profit-sharing plan, including the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, and (2) the total amount of nonelective contributions under the profit-sharing plan, excluding the qualified nonelective contributions to be used to satisfy the actual deferral percentage test, must satisfy the requirements of section 401(a)(4) on an employer-wide basis. Of course, in order for the profit-sharing plan to satisfy section 401(a), it must still satisfy sections 410(b) and 401(a)(4) on a qualified-separate-line-of-business basis.

(f) *Correction of excess contributions—*

(1) *General rule—*(i) *Permissible correction methods.* A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of elective contributions under the arrangement if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement and paragraph (b)(5) of this section, makes qualified nonelective contributions or qualified matching contributions that are treated as elective contributions under the arrangement and that, in combination with the elective contributions, satisfy the requirements of paragraph (b)(2) of this section. In addition, a cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) or paragraph (b)(2) of this section for a plan year with respect to the amount of the elective contributions under the arrangement if, in accordance with the terms of the plan that includes the cash or deferred arrangement, excess contributions are recharacterized in accordance with paragraph (f)(3) of this section, or excess contributions (and income allocable thereto) are distributed in accordance with paragraph (f)(4) of this section.

(ii) *Combination of correction methods.* A plan may use any of the correction methods described in paragraph (f)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. Thus, for example, a portion of the excess contributions for a highly compensated employee may be recharacterized under paragraph (f)(3) of this section, and the remaining portion of the excess contributions may be distributed under paragraph (f)(4) of this section. A plan may require or permit a highly compensated employee to elect whether any excess contributions are to be recharacterized or distributed.

(iii) *Impermissible correction methods.* Excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any

future year. In addition, excess contributions may not be corrected using the retroactive correction rules of § 1.401(a)(4)-11(g). See § 1.401(a)(4)-11(g) (3)(vii) and (5). See paragraph (f)(6) of this section for the effects of a failure to correct excess contributions.

(iv) *Partial distributions.* Any distribution of less than the entire amount of excess contributions with respect to any highly compensated employee is treated as a pro rata distribution of excess contributions and allocable income or loss.

(2) *Amount of excess contributions.* The amount of excess contributions for a highly compensated employee for a plan year is the amount (if any) by which the employee's elective contributions must be reduced for the employee's actual deferral ratio to equal the highest permitted actual deferral ratio under the plan. To calculate the highest permitted actual deferral ratio under a plan, the actual deferral ratio of the highly compensated employee with the highest actual deferral ratio is reduced by the amount required to cause the employee's actual deferral ratio to equal the ratio of the highly compensated employee with the next highest actual deferral ratio. If a lesser reduction would enable the arrangement to satisfy the actual deferral percentage test, only this lesser reduction may be made. This process must be repeated until the cash or deferred arrangement satisfies the actual deferral percentage test. The highest actual deferral ratio remaining under the plan after leveling is the highest permitted actual deferral ratio. Thus, for each highly compensated employee, the amount of excess contributions for a plan year is equal to the employee's elective contributions, plus qualified nonelective contributions and qualified matching contributions taken into account in determining the employee's actual deferral ratio under paragraph (g)(1) of this section, minus the amount determined by multiplying the employee's actual deferral ratio (determined after application of this paragraph (f)(2)) by the compensation used in determining the ratio. In no case may the amount of excess contributions to be recharacterized or distributed for a plan year with respect to any highly

compensated employee exceed the amount of elective contributions made on behalf of the highly compensated employee for the plan year.

(3) *Recharacterization of excess contributions*—(i) *General rule.* Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section, and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.*

(A) Excess contributions recharacterized under this paragraph (f)(3) are includable in the employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash, or on such later date permitted in paragraph (f)(3)(iv) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, section 401(a)(4) and 401(m), and paragraphs (b) and (d) of this section. This requirement is not treated as satisfied unless:

(1) The payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(i) Timely providing such forms as the Commissioner may designate to the employer and to employees whose excess contributions are recharacterized under this paragraph (f)(3); and

(ii) Timely taking such other action as the Commissioner may require; and

(2) The plan administrator accounts for the amounts as contributions by the employee for purposes of sections 72 and 6047.

(B) Recharacterized excess contributions continue to be treated as employer contributions that are elective contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraph (c) of this section; must be

## Internal Revenue Service, Treasury

## § 1.401(k)-1

deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and § 1.415-6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. See § 1.414(s)-1(c)(4)(i). Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules*—(A) *Time of recharacterization*. Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan*. The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See § 1.401(m)-1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized*. For plan years beginning after December 31,

1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated under § 1.410(b)-7(d) after application of the mandatory disaggregation rules of § 1.410(b)-7(c), as modified in § 1.401(k)-1(g)(11). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules*. If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example*. The provisions of this paragraph (f)(3) are illustrated by the following example:

*Example.* (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred to the trust on the last day of each month. Employer X includes elective contributions in compensation as permitted under § 1.414(s)-1(c)(4)(i). See § 1.401(k)-1(g)(2)(i). Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%) (B/A)
A .....	\$70,000	\$7,000	10.00
B .....	60,000	4,500	7.50
C .....	20,000	1,000	5.00
D .....	15,000	0	0